

CAPSTONE BANK

2011 Annual Report

2011 Annual Report

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This Annual Report to Shareholders contains forward-looking statements. These statements are subject to certain risks and uncertainties that could cause actual results to differ materially from those anticipated in the forward-looking statements. Factors that might cause such a difference include, but are not limited to, changes in the interest rate environment, management's business strategy, national, regional and local market conditions and legislative and regulatory conditions.

Readers should not place undue reliance on forward-looking statements, which reflect management's view only as of the date hereof. The Bank undertakes no obligation to publicly revise these forward-looking statements to reflect subsequent events or circumstances.



Independent Auditors' Report

Board of Directors and Shareholders
CapStone Bank
Raleigh, North Carolina

We have audited the balance sheets of CapStone Bank as of December 31, 2011 and 2010 and the related statements of operations, changes in shareholders' equity, and cash flows for the years then ended. These financial statements are the responsibility of the Bank's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of CapStone Bank as of December 31, 2011 and 2010, and the results of its operations and its cash flows for the years then ended, in conformity with accounting principles generally accepted in the United States of America.

Elliott Davis, PLLC

Galax, Virginia
March 21, 2012

Balance Sheets

December 31, 2011 and 2010

	<u>2011</u>	<u>2010</u>
Assets		
Cash and due from banks	\$ 2,293,449	\$ 1,389,813
Interest-bearing deposits with financial institutions	<u>204,073</u>	<u>202,708</u>
Cash and cash equivalents	2,497,522	1,592,521
Time deposits with financial institutions	18,154,218	26,511,847
Investment securities available-for-sale	43,344,629	25,667,344
Investment securities held-to-maturity (market value of \$517,000 in 2011 and \$506,000 in 2010)	500,000	500,000
Restricted equity securities	1,923,700	2,077,100
Loans, net of allowance for loan losses of \$4,183,406 and \$3,023,451 for 2011 and 2010, respectively	143,130,564	133,203,389
Property and equipment, net	206,196	302,997
Accrued income	716,356	683,834
Foreclosed properties	186,327	1,409,000
Bank owned life insurance	3,203,886	3,114,224
Other assets	<u>1,935,163</u>	<u>1,908,479</u>
Total assets	<u>\$ 215,798,561</u>	<u>\$ 196,970,735</u>
Liabilities and Shareholders' Equity		
Liabilities		
Deposits:		
Noninterest-bearing	\$ 20,240,943	\$ 12,346,218
Interest-bearing	<u>131,221,570</u>	<u>113,806,742</u>
Total deposits	151,462,513	126,152,960
Federal funds purchased and securities sold under agreements to repurchase	3,448,741	4,792,217
FHLB borrowings	31,750,000	39,000,000
Accrued interest payable	155,374	129,966
Other liabilities	<u>947,168</u>	<u>423,312</u>
Total liabilities	<u>187,763,796</u>	<u>170,498,455</u>
Shareholders' equity		
Preferred stock, 1,000,000 shares authorized; no shares issued and outstanding	-	-
Common stock, \$5 par value; 10,000,000 shares authorized; 2,594,873 and 2,594,873 shares issued and outstanding for 2011 and 2010, respectively ⁽¹⁾	12,974,365	10,812,000
Surplus	11,622,823	13,686,959
Retained earnings	2,210,357	1,534,381
Accumulated other comprehensive income	<u>1,227,220</u>	<u>438,940</u>
Total shareholders' equity	<u>28,034,765</u>	<u>26,472,280</u>
Total liabilities and shareholders' equity	<u>\$ 215,798,561</u>	<u>\$ 196,970,735</u>

⁽¹⁾ Share amounts have been adjusted retroactively to reflect a 6 for 5 stock split affected in the form of a dividend during 2011.

See Notes to Financial Statements

Statements of Operations

For the years ended December 31, 2011 and 2010

	<u>2011</u>	<u>2010</u>
Interest and dividend income		
Loans and fees on loans	\$ 7,777,649	\$ 7,738,238
Investment securities, taxable	950,431	933,295
Investment securities, exempt from tax	419,238	253,365
Time and other interest-bearing deposits	411,802	459,993
Federal funds sold	7,597	4,548
Dividends	<u>16,205</u>	<u>4,988</u>
Total interest and dividend income	<u>9,582,922</u>	<u>9,394,427</u>
Interest expense		
Deposits	1,021,528	1,529,402
Federal funds purchased and securities sold under agreements to repurchase	4,890	6,886
Borrowings	<u>584,214</u>	<u>590,834</u>
Total interest expense	<u>1,610,632</u>	<u>2,127,122</u>
Net interest income	7,972,290	7,267,305
Provision for loan losses		
Net interest income after provision for loan losses	<u>2,379,000</u>	<u>1,349,000</u>
5,593,290	<u>5,918,305</u>	
Noninterest income		
Service charges on deposit accounts	28,190	27,332
Bank owned life insurance	89,662	99,934
Gain on sale of loan participation	-	101,733
Gains on sales of investment securities	120,594	-
Other service charges and fees	<u>46,326</u>	<u>35,474</u>
Total noninterest income	<u>284,772</u>	<u>264,473</u>
Noninterest expense		
Salaries and employee benefits	3,211,940	2,248,455
Occupancy and equipment expense	396,179	408,350
Net losses on other real estate owned	45,003	316,798
Marketing expense	42,412	114,018
Information systems expense	336,306	356,321
FDIC insurance premiums	214,714	231,664
Other expense	<u>751,532</u>	<u>710,300</u>
Total noninterest expense	<u>4,998,086</u>	<u>4,385,906</u>
Net income before income taxes	879,976	1,796,872
Income tax expense		
Net income	<u>204,000</u>	<u>563,795</u>
	<u>\$ 675,976</u>	<u>\$ 1,233,077</u>
Basic earnings per common share		
	<u>\$.26</u>	<u>\$.48</u>
Diluted earnings per common share		
	<u>\$.26</u>	<u>\$.48</u>
Weighted average common shares outstanding		
	<u>2,594,873</u>	<u>2,594,873</u>
Weighted average dilutive common shares outstanding		
	<u>2,594,873</u>	<u>2,594,873</u>

See Notes to Financial Statements

Statements of Changes in Shareholders' Equity

For the years ended December 31, 2011 and 2010

	Common Stock		Surplus	Retained Earnings (Deficit)	Accumulated Other Comprehensive Income	Total
	Shares	Amount				
Balance, December 31, 2009	2,162,400	\$ 10,812,000	\$ 13,570,949	\$ 301,304	\$ 594,521	\$ 25,278,774
Comprehensive income						
Net income	-	-	-	1,233,077	-	1,233,077
Net change in unrealized appreciation on investment securities available for sale, net of tax of \$80,148	-	-	-	-	(155,581)	(155,581)
Total comprehensive income						1,077,496
Non-cash stock option expense	-	-	116,010	-	-	116,010
Balance, December 31, 2010	2,162,400	10,812,000	13,686,959	1,534,381	438,940	26,472,280
Comprehensive income						
Net income	-	-	-	675,976	-	675,976
Net change in unrealized appreciation on investment securities available for sale, net of tax of \$406,084	-	-	-	-	788,280	788,280
Total comprehensive income						1,464,256
Stock dividend issued, net of cash paid in lieu of fractional shares	432,473	2,162,365	(2,162,412)	-	-	(47)
Non-cash stock option expense	-	-	98,276	-	-	98,276
Balance, December 31, 2011	<u>2,594,873</u>	<u>\$ 12,974,365</u>	<u>\$ 11,622,823</u>	<u>\$ 2,210,357</u>	<u>\$ 1,227,220</u>	<u>\$ 28,034,765</u>

See Notes to Financial Statements

Statements of Cash Flows

For the years ended December 31, 2011 and 2010

	<u>2011</u>	<u>2010</u>
<i>Cash flows from operating activities</i>		
Net income	\$ 675,976	\$ 1,233,077
Adjustments to reconcile net income to net cash provided by operations:		
Depreciation and amortization	192,788	216,643
Provision for loan losses	2,379,000	1,349,000
Non-cash stock compensation expense	98,276	116,010
Amortization of premium on securities, net of accretion	20,644	(68,897)
Amortization of deferred gain on termination of interest rate swap agreement	(152,025)	(364,860)
Income earned on Bank owned life insurance	(89,662)	(99,934)
Gain on sales of investment securities	(120,594)	-
Loss on sales of OREO, net	5,003	-
Write-down of other real estate	40,000	225,000
Changes in assets and liabilities:		
Accrued income	(32,522)	(30,097)
Other assets	(521,204)	(323,505)
Accrued interest payable	25,408	(68,302)
Other liabilities	<u>675,880</u>	<u>(316,857)</u>
Net cash provided by operating activities	<u>3,196,968</u>	<u>1,867,278</u>
<i>Cash flows from investing activities</i>		
Net decrease in federal funds sold	-	-
Purchases of securities available-for-sale	(26,861,833)	(7,482,050)
Proceeds from maturities, calls, and principal paydown of securities available-for-sale	6,392,915	7,059,649
Proceeds from sales of securities available for sale	4,174,384	-
Net decrease (increase) in interest-bearing deposits with other financial institutions	8,357,629	(6,344,015)
Proceeds from sales of other real estate owned	1,462,670	230,000
Sales (purchases) of restricted equity securities	153,400	(768,200)
Net increase in loans	(12,591,175)	(7,433,515)
Net purchases of property and equipment	<u>(95,987)</u>	<u>(127,839)</u>
Net cash used in investing activities	<u>(19,007,997)</u>	<u>(14,865,970)</u>
<i>Cash flows from financing activities</i>		
Net increase in deposits	25,309,553	4,627,767
Net increase (decrease) in federal funds purchased and securities sold under agreements to repurchase	(1,343,476)	298,148
Net change in borrowings	(7,250,000)	7,000,000
Cash paid in lieu of fractional shares	<u>(47)</u>	<u>-</u>
Net cash provided by financing activities	<u>16,716,030</u>	<u>11,925,915</u>
Net increase (decrease) in cash and cash equivalents	905,001	(1,072,777)
<i>Cash and cash equivalents, beginning</i>	<u>1,592,521</u>	<u>2,665,298</u>
<i>Cash and cash equivalents, ending</i>	<u>\$ 2,497,522</u>	<u>\$ 1,592,521</u>
<i>Supplemental disclosure of cash flow information</i>		
Interest paid	<u>\$ 1,585,224</u>	<u>\$ 2,196,224</u>
Taxes paid	<u>\$ 983,960</u>	<u>\$ 1,019,341</u>
<i>Supplemental disclosure of non-cash activities</i>		
Other real estate acquired in settlement of loans	<u>\$ 285,000</u>	<u>\$ 1,759,000</u>

See Notes to Financial Statements

Notes to Financial Statements

Note 1. Organization and Summary of Significant Accounting Policies

Organization

CapStone Bank (the Bank) was organized and incorporated under the laws of the State of North Carolina and commenced operations on August 1, 2006. The Bank currently serves the city of Raleigh and Wake County, North Carolina and surrounding areas through its banking office in Raleigh, North Carolina and a loan production office in Cary, North Carolina. As a state chartered bank, which is not a member of the Federal Reserve, the Bank is subject to regulation by the State of North Carolina Banking Commission and the Federal Deposit Insurance Corporation.

The accounting and reporting policies of the Bank follow generally accepted accounting principles and general practices within the financial services industry. Following is a summary of the more significant policies:

Critical Accounting Policies

Management believes policies with respect to the methodology for the determination of the allowance for loan losses involve a high degree of complexity. Management must make difficult and subjective judgments which require assumptions or estimates about highly uncertain matters. Changes in these judgments, assumptions or estimates could cause reported results to differ materially.

Business Segments

The Bank reports its activities as a single business segment. In determining the appropriateness of segment definition, the Bank considers the materiality of a potential segment and components of the business about which financial information is available and regularly evaluated relative to resource allocation and performance assessment.

Use of Estimates

In preparing financial statements in conformity with accounting principles generally accepted in the United States of America, management is required to make estimates and assumptions that affect the reported amounts of assets and liabilities as of the date of the balance sheet and reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates. Material estimates that are particularly susceptible to significant change in the near term relate to the determination of the allowance for loan losses and the valuation of deferred tax assets.

Cash and Cash Equivalents

For the purpose of presentation in the statement of cash flows, cash and cash equivalents are defined as those amounts included in the balance sheet caption “cash and due from banks” and “interest-bearing deposits with financial institutions.”

Securities

Certain debt securities that management has the positive intent and ability to hold to maturity are classified as “held-to-maturity” and recorded at amortized cost. Trading securities are recorded at fair value with changes in fair value included in earnings. Securities not classified as held-to-maturity or trading, including equity securities with readily determinable fair values, are classified as “available-for-sale” and recorded at fair value, with unrealized gains and losses excluded from earnings and reported in other comprehensive income. The Bank held no trading securities during the years presented.

Purchase premiums and discounts are recognized in interest income using the interest method over the terms of the securities. Declines in the fair value of held-to-maturity and available-for-sale securities below their cost that are deemed to be other than temporary are reflected in earnings as realized losses. In determining whether other-than-temporary impairment exists, management considers many factors, including (1) the length of time and the extent to which the fair value has been less than cost, (2) the financial condition and near-term prospects of the issuer, and (3) the intent and ability of the Bank to retain its investment in the issuer for a period of time sufficient to allow for any anticipated recovery in fair value. Gains and losses on the sale of securities are recorded on the trade date and are determined using the specific identification method.

Notes to Financial Statements

Note 1. Organization and Summary of Significant Accounting Policies, continued

Loans Receivable

Loans receivable that management has the intent and ability to hold for the foreseeable future or until maturity or pay-off are reported at their outstanding principal amount adjusted for any charge-offs and the allowance for loan losses. Loan origination fees, net of certain direct origination costs, are deferred and recognized as an adjustment of the related loan yield using the interest method. Discounts and premiums on any purchased loans are amortized to income using the interest method over the remaining period to contractual maturity, adjusted for anticipated prepayments.

Interest is accrued and credited to income based on the principal amount outstanding. The accrual of interest on impaired loans is discontinued when, in management's opinion, the borrower may be unable to meet payments as they become due. When interest accrual is discontinued, all unpaid accrued interest for the current year is reversed. Interest income is subsequently recognized on the cash-basis or cost-recovery method, as appropriate. When facts and circumstances indicate the borrower has regained the ability to meet the required payments, the loan is returned to accrual status. Past due status of loans is determined based on contractual terms.

Allowance for Loan Losses

The allowance for loan losses is established as losses are estimated to have occurred through a provision for loan losses charged to earnings. Loan losses are charged against the allowance when management believes the uncollectibility of a loan balance is confirmed. Subsequent recoveries, if any, are credited to the allowance.

The allowance for loan losses is evaluated on a regular basis by management and is based upon management's periodic review of the collectibility of the loans in light of historical experience, the nature and volume of the loan portfolio, adverse situations that may affect the borrower's ability to repay, estimated value of any underlying collateral and prevailing economic conditions. This evaluation is inherently subjective as it requires estimates that are susceptible to significant revision as more information becomes available.

A loan is considered impaired when, based on current information and events, it is probable that the Bank will be unable to collect the scheduled payments of principal or interest when due according to the contractual terms of the loan agreement. Factors considered by management in determining impairment include payment status and other circumstances impacting the probability of collecting scheduled principal and interest payments when due. Loans that experience insignificant payment delays and payment shortfalls generally are not classified as impaired. Management determines the significance of payment delays and payment shortfalls on a case-by-case basis, taking into consideration all of the circumstances surrounding the loan and the borrower, including the length of the delay, the reasons for the delay, the borrower's prior payment record, and the amount of the shortfall in relation to the principal and interest owed. Impairment is measured on a loan by loan basis for commercial and construction loans by either the present value of expected future cash flows discounted at the loan's effective interest rate, the loan's obtainable market price, or the fair value of the collateral if the loan is collateral dependent.

Large groups of smaller balance homogeneous loans are collectively evaluated for impairment. Accordingly, the Bank does not separately identify individual consumer and residential loans for impairment disclosures, unless such loans are the subject of a restructuring agreement.

Derivative Financial Instruments

Derivative financial instruments are recognized as assets and liabilities on the balance sheet and measured at fair value.

Interest Rate Swap Agreements

For asset/liability management purposes, the Bank periodically uses interest rate swap agreements to hedge various exposures or to modify interest rate characteristics of various balance sheet accounts. Interest rate swaps are contracts in which a series of interest rate payments are exchanged over a prescribed period. The notional amount on which the interest payments are based is not exchanged. These swap agreements are derivative instruments and generally convert a portion of the Bank's variable-rate loans to a fixed rate (cash flow hedge).

Notes to Financial Statements

Note 1. Organization and Summary of Significant Accounting Policies, continued

Derivative Financial Instruments, continued

Interest Rate Swap Agreements, continued

The gain or loss on a derivative designated and qualifying as a fair value hedging instrument, as well as the offsetting gain or loss on the hedged item attributable to the risk being hedged, is recognized currently in earnings in the same accounting period. The effective portion of the gain or loss on a derivative designated and qualifying as a cash flow hedging instrument is initially reported as a component of other comprehensive income and subsequently reclassified into earnings in the same period or periods during which the hedged transaction affects earnings. The ineffective portion of the gain or loss on the derivative instrument, if any, is recognized currently in earnings.

For cash flow hedges, the net settlement (upon close-out or termination) that offsets changes in the value of the hedged asset or liability is deferred and amortized into net interest income over the life of the hedged asset or liability. For fair value hedges, the net settlement (upon close-out or termination) that offsets changes in the value of the loans adjusts the basis of the loans and is deferred and amortized to loan interest income over the life of the loans. The portion, if any, of the net settlement amount that did not offset changes in the value of the hedged asset or liability is recognized immediately in non-interest income.

Interest rate derivative financial instruments receive hedge accounting treatment only if they are designated as a hedge and are expected to be, and are, effective in substantially reducing interest rate risk arising from the assets and liabilities identified as exposing the Bank to risk. Those derivative financial instruments that do not meet specified hedging criteria would be recorded at fair value with changes in fair value recorded in income. If periodic assessment indicated derivatives no longer provide an effective hedge, the derivative contracts would be closed out and settled, or classified as a trading activity.

Cash flows resulting from the derivative financial instruments that are accounted for as hedges of assets and liabilities are classified in the cash flow statement in the same category as the cash flows of the item being hedged. There were no Interest Rate Swap Agreements for the years shown.

Foreclosed Properties

Real estate properties acquired through, or in lieu of, loan foreclosure are to be sold and are initially recorded at fair value less anticipated cost to sell at the date of foreclosure establishing a new cost basis. After foreclosure, valuations are periodically performed by management, and the real estate is carried at the lower of carrying amount or fair value less cost to sell. Revenue and expenses from operations and changes in the valuation allowance are included in loss on foreclosed real estate. The Bank held three foreclosed properties with a total carrying amount of \$186,327 at December 31, 2011. The Bank held four foreclosed properties with a total carrying amount of \$1,409,000 at December 31, 2010.

Property and Equipment

Bank premises, furniture and equipment, and leasehold improvements are carried at cost, less accumulated depreciation and amortization computed by the straight-line method over the following estimated useful lives:

	<u>Years</u>
Furniture and equipment	2-5
Computers and software	5

Notes to Financial Statements

Note 1. Organization and Summary of Significant Accounting Policies, continued

Transfers of Financial Assets

Transfers of financial assets are accounted for as sales when control over the assets has been surrendered. Control over transferred assets is deemed to be surrendered when (1) the assets have been isolated from the Bank, (2) the transferee obtains the right (free of conditions that constrain it from taking advantage of that right) to pledge or exchange the transferred assets, and (3) the Bank does not maintain effective control over the transferred assets through an agreement to repurchase them before their maturity.

Advertising Expense

The Bank expenses advertising costs as they are incurred. These costs are included in marketing expense as presented in the statements of operations.

Income Taxes

Provision for income taxes is based on amounts reported in the statements of operations (after exclusion of non-taxable income such as interest on state and municipal securities) and consists of taxes currently due plus deferred taxes on temporary differences in the recognition of income and expense for tax and financial statement purposes. Deferred tax assets and liabilities are included in the financial statements at currently enacted income tax rates applicable to the period in which the deferred tax assets or liabilities are expected to be realized or settled. Deferred income tax assets and liabilities are determined using the liability (or balance sheet) method. Under this method, the net deferred tax asset or liability is determined based on the tax effects of the temporary differences between the book and tax bases of the various balance sheet assets and liabilities and gives current recognition to changes in tax rates and laws.

Tax positions are analyzed in accordance with generally accepted accounting principles. Interest recognized as a result of the analysis of tax positions would be classified as interest expense. Penalties would be classified as noninterest expense.

Basic Earnings per Share

Basic earnings per share is computed by dividing income available to common shareholders by the weighted average number of common shares outstanding during the period, after giving retroactive effect to stock splits and dividends.

Diluted Earnings per Share

The computation of diluted earnings per share is similar to the computation of basic earnings per share except that the denominator is increased to include the number of additional common shares that would have been outstanding if dilutive potential common shares had been issued. The numerator is adjusted for any changes in income or loss that would result from the assumed conversion of those potential common shares.

Comprehensive Income

Annual comprehensive income reflects the change in the Bank's equity during the year arising from transactions and events other than investment by and distributions to shareholders. It consists of net income plus certain other changes in assets and liabilities that are reported as separate components of shareholders' equity rather than as income or expense.

Stock Compensation Plans

The Bank recognizes compensation cost relating to share-based payment transactions in accordance with generally accepted accounting principles. That cost is measured based on the fair value of the equity or liability instruments issued. The expense measures the cost of employee services received in exchange for stock options based on the grant-date fair value of the award and recognizes the cost over the period the employee is required to provide services for the award.

Notes to Financial Statements

Note 1. Organization and Summary of Significant Accounting Policies, continued

Fair Value of Financial Instruments

Generally accepted accounting principles (“GAAP”) define fair value as the exchange price that would be received for an asset or paid to transfer a liability (an exit price) in the principal or most advantageous market for the asset or liability in an orderly transaction between market participants on the measurement date. The Bank determines the fair values of its financial instruments based on the fair value hierarchy established per GAAP which requires an entity to maximize the use of observable inputs and minimize the use of unobservable inputs when measuring fair value. Investment securities available-for-sale are recorded at fair value on a recurring basis. Certain impaired loans and foreclosed properties are carried at fair value on a non-recurring basis.

Reclassification

Certain amounts in the prior year financial statements have been reclassified to conform to the current year presentation. Net income and shareholders’ equity previously reported were not affected by these reclassifications.

Subsequent Events

These financial statements have been updated for subsequent events occurring through March 21, 2012 which is the date these financial statements were available to be issued.

Recent Accounting Pronouncements

The following is a summary of recent authoritative pronouncements:

In July 2010, the Receivables topic of the Accounting Standards Codification (“ASC”) was amended by Accounting Standards Update (“ASU”) 2010-20 to require expanded disclosures related to a company’s allowance for credit losses and the credit quality of its financing receivables. The amendments require the allowance disclosures to be provided on a disaggregated basis. The Bank is required to include these disclosures in its annual financial statements. See Note 5.

In April 2011 the FASB issued ASU 2011-02 to assist creditors with their determination of when a restructuring is a Troubled Debt Restructuring (“TDR”). The determination is based on whether the restructuring constitutes a concession and whether the debtor is experiencing financial difficulties as both events must be present. The new guidance is effective for the Bank beginning January 1, 2012 and is not expected to have a material effect on the Bank’s TDR determinations.

In April 2011, the criteria used to determine effective control of transferred assets in the Transfers and Servicing topic of the ASC was amended by ASU 2011-03. The requirement for the transferor to have the ability to repurchase or redeem the financial assets on substantially the agreed terms and the collateral maintenance implementation guidance related to that criterion were removed from the assessment of effective control. The other criteria to assess effective control were not changed. The amendments are effective for the Bank beginning January 1, 2012 but are not expected to have a material effect on the financial statements.

ASU 2011-04 was issued in May 2011 to amend the Fair Value Measurement topic of the ASC by clarifying the application of existing fair value measurement and disclosure requirements and by changing particular principles or requirements for measuring fair value or for disclosing information about fair value measurements. The amendments were effective for the Bank beginning January 1, 2012 but are not expected to have a material effect on the financial statements.

Notes to Financial Statements

Note 1. Organization and Summary of Significant Accounting Policies, continued

Recent Accounting Pronouncements, continued

The Comprehensive Income topic of the ASC was amended in June 2011. The amendment eliminates the option to present other comprehensive income as a part of the statement of changes in stockholders' equity and requires consecutive presentation of the statement of net income and other comprehensive income. The amendments will be applicable to the Bank for the year ended December 31, 2012 and will be applied retrospectively. In December 2011, the topic was further amended to defer the effective date of presenting reclassification adjustments from other comprehensive income to net income on the face of the financial statements. Companies should continue to report reclassifications out of accumulated other comprehensive income consistent with the presentation requirements in effect prior to the amendments while FASB redeliberates future requirements.

Other accounting standards that have been issued or proposed by the FASB or other standards-setting bodies are not expected to have a material impact on the Bank's financial position, results of operations or cash flows.

Note 2. Restrictions on Cash

To comply with banking regulations, the Bank is required to maintain certain average cash reserve balances. The daily average cash reserve requirement was approximately \$815,000 and \$478,000 for the periods including December 31, 2011 and 2010, respectively.

Note 3. Securities

Debt and equity securities have been classified in the balance sheet according to management's intent. The carrying amount of securities and their approximate fair values at December 31, 2011 and 2010 are:

	<u>Amortized Cost</u>	<u>Unrealized Gains</u>	<u>Unrealized Losses</u>	<u>Fair Value</u>
2011				
<i>Available-for-sale</i>				
Government sponsored enterprises	\$ 1,000,000	\$ 32,212	\$ -	\$ 1,032,212
Municipal securities	13,502,268	822,616	(9,224)	14,315,660
Mortgage-backed securities	<u>26,845,258</u>	<u>1,156,469</u>	<u>(4,970)</u>	<u>27,996,757</u>
	<u>\$ 41,347,526</u>	<u>\$ 2,011,297</u>	<u>\$ (14,194)</u>	<u>\$ 43,344,629</u>
<i>Held-to-maturity</i>				
Subordinated debt	<u>\$ 500,000</u>	<u>\$ 17,000</u>	<u>\$ -</u>	<u>\$ 517,000</u>
2010				
<i>Available-for-sale</i>				
Government sponsored enterprises	\$ 1,000,000	\$ 17,757	\$ -	\$ 1,017,757
Municipal securities	8,994,287	59,905	(160,795)	8,893,397
Mortgage-backed securities	<u>14,958,753</u>	<u>825,858</u>	<u>(28,421)</u>	<u>15,756,190</u>
	<u>\$ 24,953,040</u>	<u>\$ 903,520</u>	<u>\$ (189,216)</u>	<u>\$ 25,667,344</u>
<i>Held-to-maturity</i>				
Subordinated debt	<u>\$ 500,000</u>	<u>\$ 6,000</u>	<u>\$ -</u>	<u>\$ 506,000</u>

All of the Bank's mortgage-backed securities are issued and guaranteed by U.S. Government sponsored enterprises.

Restricted equity securities consist of investments in common stock of the Federal Home Loan Bank of Atlanta ("FHLB"). The FHLB requires financial institutions to make equity investments in the FHLB in order to borrow from it. The Bank is required to hold that stock so long as it borrows from the FHLB.

Notes to Financial Statements

Note 3. Securities, continued

Investment securities with amortized cost of \$5,736,879 at December 31, 2011 were pledged as collateral for other purposes as required or permitted by law.

The Bank did not realize any gains or losses during 2010, but realized \$28,656 in losses and \$142,250 in gains during 2011.

The following table details unrealized losses and related fair values in the Bank's available-for-sale investment securities portfolios. This information is aggregated by the length of time that individual securities have been in a continuous unrealized loss position as of December 31, 2011 and 2010.

	<u>Less Than 12 Months</u>		<u>Total</u>	
	<u>Fair Value</u>	<u>Unrealized Losses</u>	<u>Fair Value</u>	<u>Unrealized Losses</u>
2011				
<i>Available for sale</i>				
Municipal securities	\$ 1,424,463	\$ 9,223	\$ 1,424,463	\$ 9,223
Mortgage-backed securities	967,745	4,970	967,745	4,970
Total temporarily impaired securities	<u>\$ 2,392,208</u>	<u>\$ 14,193</u>	<u>\$ 2,392,208</u>	<u>\$ 14,193</u>
2010				
<i>Available for sale</i>				
Municipal securities	\$ 6,171,973	\$ 160,795	\$ 6,171,973	\$ 160,795
Mortgage-backed securities	1,457,701	28,421	1,457,701	28,421
Total temporarily impaired securities	<u>\$ 7,629,674</u>	<u>\$ 189,216</u>	<u>\$ 7,629,674</u>	<u>\$ 189,216</u>

At December 31, 2011, the Bank had five debt securities which had aggregately depreciated .6% in value from the amortized cost. The depreciation was related to increases in the current interest rates for similar issues of securities. In analyzing an issuer's financial condition, management considers whether the securities are issued by the federal government or its agencies, whether downgrades by bond rating agencies have occurred, and the results of reviews of the issuer's financial condition. Management believes all unrealized losses presented in the table above to be temporary in nature.

Management considers the nature of the investment, the underlying causes of the decline in market value, the severity and duration of the decline in market value and other evidence, on a security by security basis, in determining if the decline in market value is other than temporary.

The scheduled contractual maturities of securities at December 31, 2011 are shown below. Expected maturities could differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties.

	<u>Available-for-Sale</u>		<u>Held-to-Maturity</u>	
	<u>Amortized Cost</u>	<u>Fair Value</u>	<u>Amortized Cost</u>	<u>Fair Value</u>
Due in one year or less	\$ 5,486,272	\$ 5,743,405	\$ -	\$ -
Due after one year through five years	12,878,804	13,435,259	-	-
Due after five years through ten years	15,361,849	16,145,718	500,000	517,000
Due after ten years	7,620,601	8,020,247	-	-
	<u>\$ 41,347,526</u>	<u>\$ 43,344,629</u>	<u>\$ 500,000</u>	<u>\$ 517,000</u>

Notes to Financial Statements

Note 4. Loans Receivable

The major components of loans in the balance sheet at December 31, 2011 and 2010 are as follows:

	<u>2011</u>	<u>2010</u>
Commercial	\$ 14,989,451	\$ 11,178,579
Real estate:		
Construction and development	23,676,678	16,299,827
Residential, 1-4 families	34,872,098	29,246,256
Multi-family residential	6,011,172	8,077,145
Nonfarm nonresidential	63,465,981	63,022,050
Farmland	890,321	1,093,857
Consumer	3,173,624	6,675,438
Other	502,171	802,681
Deferred loan fees, net	<u>(267,526)</u>	<u>(168,993)</u>
	147,313,970	136,226,840
Allowance for loan losses	<u>(4,183,406)</u>	<u>(3,023,451)</u>
	<u>\$ 143,130,564</u>	<u>\$ 133,203,389</u>

Note 5. Allowance for Loan Losses

The allocation of the allowance for loan losses by loan components (in thousands) at December 31, 2011 is as follows:

	<u>Commercial</u>	<u>Construction & Development</u>	<u>Residential</u>	<u>Nonresidential</u>	<u>Consumer & Other</u>	<u>Total</u>
2011						
Allowance for credit losses:						
Beginning balance	\$ 248	\$ 361	\$ 827	\$ 1,421	\$ 166	\$ 3,023
Charge-offs		(262)	(662)	(300)		(1,224)
Recoveries			5			5
Provision	<u>177</u>	<u>572</u>	<u>989</u>	<u>703</u>	<u>(62)</u>	<u>2,379</u>
Ending balance	<u>\$ 425</u>	<u>\$ 671</u>	<u>\$ 1,159</u>	<u>\$ 1,824</u>	<u>\$ 104</u>	<u>\$ 4,183</u>
Ending balance: individually evaluated for impairment	<u>\$ 50</u>	<u>\$ 492</u>	<u>\$ 194</u>	<u>\$ 793</u>	<u>\$ -</u>	<u>\$ 1,529</u>
Ending balance: collectively evaluated for impairment	<u>\$ 375</u>	<u>\$ 179</u>	<u>\$ 965</u>	<u>\$ 1,031</u>	<u>\$ 104</u>	<u>\$ 2,654</u>
Loans Receivables:						
Ending balance	<u>\$ 14,989</u>	<u>\$ 23,677</u>	<u>\$ 40,883</u>	<u>\$ 64,089</u>	<u>\$ 3,676</u>	<u>\$ 147,314</u>
Ending balance: individually evaluated for impairment	<u>\$ 257</u>	<u>\$ 3,835</u>	<u>\$ 5,081</u>	<u>\$ 3,680</u>	<u>\$ 60</u>	<u>\$ 12,913</u>
Ending balance: collectively evaluated for impairment	<u>\$ 14,732</u>	<u>\$ 19,842</u>	<u>\$ 35,802</u>	<u>\$ 60,409</u>	<u>\$ 3,616</u>	<u>\$ 134,401</u>

An analysis of the allowance for loan losses for the year ended is as follows:

	<u>2010</u>
Balance at beginning of period	\$ 2,437,317
Provision for loan losses charged to operations	1,349,000
Recoveries of amounts charged off	25,000
Amounts charged off	<u>(787,866)</u>
Balance at end of period	<u>\$ 3,023,451</u>

Notes to Financial Statements

Note 6. Allowance for Loan Losses, continued

The following table presents impaired loans by class of loan (in thousands) as of December 31, 2011:

	<u>Recorded Investment</u>	<u>Unpaid Principal Balance</u>	<u>Related Allowance</u>	<u>Average Recorded Investment</u>	<u>Interest Income Recognized</u>
2011					
With no related allowance recorded:					
Commercial	\$ 51	\$ 51	\$ -	\$ 55	\$ 4
Construction and development	1,593	1,886	-	1,725	70
Residential	1,713	1,734	-	1,762	85
Nonresidential	2,080	2,096	-	2,102	131
Consumer and other	60	60	-	103	7
	<u>5,497</u>	<u>5,827</u>	<u>-</u>	<u>5,747</u>	<u>297</u>
With an allowance recorded:					
Commercial	207	209	50	221	14
Construction and development	2,242	2,274	492	2,247	151
Residential	3,369	4,042	194	3,723	127
Nonresidential	1,600	1,933	793	1,750	69
	<u>7,418</u>	<u>8,458</u>	<u>1,529</u>	<u>7,941</u>	<u>361</u>
Combined:					
Commercial	\$ 257	\$ 260	\$ 50	\$ 276	\$ 18
Construction and development	3,835	4,160	492	3,972	221
Residential	5,081	5,776	194	5,484	212
Nonresidential	3,680	4,029	793	3,852	200
Consumer and other	60	60	-	103	7
	<u>\$ 12,913</u>	<u>\$ 14,285</u>	<u>\$ 1,529</u>	<u>\$ 13,687</u>	<u>\$ 658</u>

The following is a summary of information pertaining to impaired loans at December 31, 2010:

	<u>2010</u>
Impaired loans without a valuation allowance	\$ 1,485,243
Impaired loans with a valuation allowance	4,598,777
Total impaired loans	<u>\$ 6,084,020</u>
Valuation allowance related to impaired loans	<u>\$ 737,846</u>
Total nonaccrual loans (all included in impaired loans)	<u>\$ 542,030</u>
Total loans past due ninety days or more and still accruing interest	<u>\$ -</u>

Nonperforming loans and impaired loans are defined differently. As such, some loans may be included in both categories, whereas other loans may only be included in one category. The following table represents loans past due as of December 31, 2011 (in thousands).

	<u>30-89 Days Past Due</u>	<u>90 Days Plus Past Due</u>	<u>Total Past Due</u>	<u>Current</u>	<u>Total Loans Receivables</u>	<u>Recorded Investment > 90 Days and Accruing</u>
2011						
Commercial	\$ -	\$ -	\$ -	\$ 14,989	\$ 14,989	\$ -
Construction and development	224	1,005	1,229	22,448	23,677	199
Residential	-	3,413	3,413	37,470	40,883	243
Nonresidential	2,054	1,892	3,946	60,143	64,089	301
Consumer and other	-	-	-	3,676	3,676	-
Total	<u>\$ 2,278</u>	<u>\$ 6,310</u>	<u>\$ 8,588</u>	<u>\$ 138,726</u>	<u>\$ 147,314</u>	<u>\$ 743</u>

Notes to Financial Statements

Note 6. Allowance for Loan Losses, continued

Credit Quality Indicators:

The Bank has established a standard risk grading (also referred to as loan grade) system to assist management and lenders in their analysis and supervision of the loan portfolio. Loan officers assign a grade to each credit at its inception; this grade is changed as required thereafter based on the borrower's financial condition, payment performance, and other material information.

The Bank uses the following definitions for risk ratings:

Pass	Borrowers with at least adequate sources of repayments, with little identifiable risk of collection. These loans will generally conform to the Bank's policy requirements, product guidelines and underwriting standards, with limited exceptions. Any exceptions that are identified during the underwriting and approval process have been adequately mitigated by other factors.
Special Mention	Borrowers currently posing a higher than normal risk. Loans are protected, but have potentially developing weaknesses, which could include stale credit or some degree of difficulty in servicing debt, increased leverage, marginal profitability or interim unprofitability, etc. indicative of a possible transition in financial condition. Risk concern has heightened, but concern has not escalated to a point where reclassification of the asset to impaired is warranted.
Substandard	Relationships which have one or more well defined credit weaknesses, impairing collectability and necessitating workout. Factors might include: inadequate repayment capacity; severe erosion of equity; likely reliance on collateral for repayment, which may be questionable; guarantors with limited resources; obvious deterioration in financial condition/adverse trends; possibility of loss or protracted workout exists if immediate corrective action is not taken.
Doubtful	Relationship displays many of the same weaknesses as a substandard; however, those risk factors are more dominant. Collectability is severely jeopardized and loss potential is extreme; however, the loss cannot be quantified with any degree of accuracy due to circumstances surrounding the loan. Once the loss is able to be quantified, that amount will be charged-off.

The following table represents classified loans as of December 31, 2011 (in thousands).

	<u>Total</u>	<u>Pass</u>	<u>Special Mention</u>	<u>Substandard</u>	<u>Doubtful</u>
<u>December 31, 2011</u>					
Commercial	\$ 14,989	\$ 14,732	\$ 95	\$ 162	\$ -
Construction and development	23,667	19,842	-	3,835	-
Residential	40,883	35,802	170	4,911	-
Nonresidential	64,089	60,409	1,200	2,480	-
Consumer and other	3,676	3,616	10	50	-
Total	<u>\$ 147,314</u>	<u>\$ 134,401</u>	<u>\$ 1,475</u>	<u>\$ 11,438</u>	<u>\$ -</u>
	100%	91%	1%	8%	-%

Nonaccrual Loans (in thousands) as of December 31, 2011

	<u>2011</u>
Construction and development	\$ 812
Residential	3,182
Nonresidential	1,600
Total	<u>\$ 5,594</u>

Notes to Financial Statements

Note 6. Allowance for Loan Losses, continued

Trouble Debt Restructuring

During the year ended December 31, 2011, the Bank modified six loans that were considered to be troubled debt restructurings. The Bank extended the terms for all of these loans. No other terms were modified for any of these loans. The following table is a summary of information related to loan modifications during 2011:

	Modifications During 2011		
		2011	
	Number of Contracts	Pre-Modification Outstanding Recorded Investment (1)	Post- Modification Outstanding Recorded Investment (1)
Troubled Debt Restructurings			
Commercial	1	\$ 174,960	\$ 174,960
Construction and development	2	269,492	269,492
Residential	2	539,155	539,155
Nonresidential	1	700,000	700,000
Total Troubled Debt Restructuring during 2011	<u>6</u>	<u>\$ 1,683,607</u>	<u>\$ 1,683,607</u>

During the year ended December 31, 2011, one loan that had previously been restructured was in default. Restructured loans are deemed to be in default if payments in accordance with the modified terms are not received within ninety days of the payment due date.

	Number of Contracts	Recorded Investment (1)
Troubled Debt Restructurings That Subsequently Defaulted		
Troubled debt restructurings:		
Nonresidential	<u>1</u>	<u>\$ 713,057</u>

In the determination of the allowance for loan losses, management considers troubled debt restructurings as impaired.

(1) Recorded investment includes unpaid active principal outstanding and accrued interest.

Note 7. Property and Equipment

Components of Property and Equipment

Components of property and equipment and total accumulated depreciation at December 31, 2011 and 2010 are as follows:

	2011	2010
Furniture and equipment	\$ 854,601	\$ 829,294
Computers and software	<u>265,913</u>	<u>210,326</u>
Property and equipment, total	1,120,514	1,036,620
Less accumulated depreciation	<u>(914,318)</u>	<u>(736,623)</u>
Property and equipment, net of depreciation	<u>\$ 206,196</u>	<u>\$ 302,997</u>

Notes to Financial Statements

Note 7. Property and Equipment, continued

Leases

The Bank has entered into an operating lease on its banking office in Raleigh, North Carolina. The amended term of this lease commenced on May 1, 2008 and will remain in effect through June 30, 2013, at which time the Bank has the option to extend the lease for one additional term of five years. During 2009, the Bank entered into a one year operating lease for a loan office in Cary, North Carolina which took effect on February 1, 2010. The Bank has extended this lease to February 1, 2012. The Bank's total rent expense for 2011 and 2010 was \$229,505 and \$222,536, respectively.

Future minimum payments under non-cancelable operating lease agreements are as follows:

<u>Year</u>	<u>Amount</u>
2012	\$ 218,354
2013	109,726
Thereafter	-
Total	<u>\$ 328,080</u>

Note 8. Deposits

The aggregate amount of time deposits in denominations of one hundred thousand dollars or more at December 31, 2011 and 2010 was approximately \$49,447,000 and \$47,547,000, respectively. At December 31, 2011, the scheduled maturities of time deposits (in thousands) are as follows:

	<u>Less Than \$100,000</u>	<u>\$100,000 or More</u>	<u>Total</u>
2012	\$ 5,038	\$ 38,250	\$ 43,288
2013 thru 2014	1,732	10,276	12,008
2015 and later	100	921	1,021
	<u>\$ 6,870</u>	<u>\$ 49,447</u>	<u>\$ 56,317</u>

Note 9. Borrowings

Federal Funds Purchased and Securities Sold Under Agreements to Repurchase

Short-term debt consists of federal funds purchased and securities sold under agreements to repurchase, which generally mature within one day of the transaction date. Additional information is summarized below:

	<u>2011</u>	<u>2010</u>
Outstanding balance at December 31	<u>\$ 3,448,741</u>	<u>\$ 4,792,217</u>
Year-end weighted average rate	<u>.13%</u>	<u>.15%</u>
Daily average outstanding during the period	<u>\$ 3,755,012</u>	<u>\$ 4,278,679</u>
Average rate for the period	<u>.16%</u>	<u>.19%</u>
Maximum outstanding at any month-end during the period	<u>\$ 7,815,471</u>	<u>\$ 7,299,786</u>

Securities sold under agreements to repurchase amounted to \$3,183,741 and \$3,677,217 at December 31, 2011 and 2010, respectively, which mature on a daily basis and are collateralized by securities issued by U.S. Government sponsored enterprises.

The Bank has established credit facilities to provide additional liquidity if and as needed. These consist of unsecured lines of credit with correspondent banks totaling \$18,800,000. At December 31, 2011 and 2010, \$265,000 and \$1,115,000 was outstanding under these credit facilities, respectively.

Notes to Financial Statements

Note 9. Borrowings, continued

FHLB Borrowings

The Bank has an available line of credit with the FHLB equal to 25% of total assets. Advances under this line are secured by qualifying loans amounting to approximately \$76,307,000.

Advances from the FHLB of Atlanta (in thousands) consisted of the following at December 31, 2011 and 2010.

<u>Maturity</u>	<u>Interest Rate</u>	<u>2011</u>	<u>2010</u>
February 14, 2011	0.60%	\$ -	\$ 1,000
March 16, 2011	0.28%	-	3,000
March 17, 2011	0.28%	-	4,000
March 21, 2011	0.66%	-	500
May 16, 2011	1.65%	-	2,000
October 7, 2011	0.94%	-	1,250
October 14, 2011	0.29%	-	3,000
October 24, 2011	0.31%	-	2,000
November 21, 2011	1.31%	-	2,000
December 2, 2011	1.04%	-	1,000
January 19, 2012	0.25%	1,000	-
January 29, 2012	1.19%	1,000	1,000
February 14, 2012	0.43%	1,000	-
March 21, 2012	0.34%	500	-
April 9, 2012	1.28%	1,250	1,250
April 16, 2012	1.22%	1,000	1,000
July 3, 2012	0.36%	1,000	-
August 3, 2012	0.25%	1,000	-
September 7, 2012	4.05%	3,000	3,000
November 5, 2012	0.48%	1,000	1,000
November 9, 2012	0.28%	1,000	-
December 3, 2012	0.29%	1,000	-
January 18, 2013	0.52%	1,000	-
February 21, 2013	0.44%	1,000	-
April 22, 2013	2.55%	2,000	2,000
April 29, 2013	1.95%	1,000	1,000
May 16, 2013	0.72%	2,000	-
May 21, 2013	1.62%	2,000	2,000
November 8, 2013	0.56%	2,000	-
March 28, 2014	2.48%	1,000	1,000
May 21, 2014	2.09%	2,000	2,000
September 2, 2014	2.96%	2,000	2,000
March 5, 2018	3.68%	2,000	2,000
		<u>\$ 31,750</u>	<u>\$ 39,000</u>

Note 10. Fair Value of Financial Instruments

Fair Value Hierarchy

There are three levels of inputs in the fair value hierarchy that may be used to measure fair value. Financial instruments are considered *Level 1* when valuation can be based on quoted prices in active markets for identical assets or liabilities. *Level 2* financial instruments are valued using quoted prices for similar assets or liabilities; quoted prices in markets that are not active; or models using inputs that are observable or can be corroborated by observable market data of substantially the full term of the assets or liabilities. Financial instruments are considered *Level 3* when their values are determined using pricing models, discounted cash flow methodologies or similar techniques and at least one significant model assumption or input is unobservable and when determination of the fair value requires significant management judgment or estimation.

Notes to Financial Statements

Note 10 Fair Value of Financial Instruments, continued

Financial Instruments Measured at Fair Value

The following sections provide a description of the valuation methodologies used for instruments measured at fair value, as well as the general classification of such instruments pursuant to the fair value hierarchy:

Securities: Where quoted prices are available in an active market, securities are classified within Level 1 of the valuation hierarchy. Level 1 securities would include highly liquid government bonds, mortgage products and exchange traded equities. If quoted market prices are not available, then fair values are estimated by using pricing models, quoted prices of securities with similar characteristics, or discounted cash flow. Level 2 securities would include U.S. agency securities, mortgage-backed agency securities, obligations of states and political subdivisions and certain corporate, asset backed and other securities. In certain cases where there is limited activity or less transparency around inputs to the valuation, securities are classified within Level 3 of the valuation hierarchy.

Impaired Loans: Impairment of a loan is based on a loan's observable market price or the fair value of the collateral of a collateral-dependent loan. Fair value of the loan's collateral, when the loan is dependent on collateral, is determined by appraisals or independent valuation which is then adjusted for the cost related to liquidation of the collateral.

Foreclosed Properties: Foreclosed assets are adjusted to fair value upon transfer of the loans to other real estate owned. Real estate acquired in settlement of loans is recorded initially at estimated fair value of the property less estimated selling costs at the date of foreclosure. The initial recorded value may be subsequently reduced by additional allowances, which are charged to earnings if the estimated fair value of the property less estimated selling costs declines below the initial recorded value. Fair value is based upon independent market prices, appraised values of the collateral or management's estimation of the value of the collateral.

Recurring Fair Value

The table below presents the recorded amount of assets and liabilities measured at fair value on a recurring basis.

<u>December 31, 2011</u>	<u>Total</u>	<u>Level 1</u>	<u>Level 2</u>	<u>Level 3</u>
Investment securities available-for-sale:				
U.S. Government agencies	\$ 1,032,212	\$ -	\$ 1,032,212	\$ -
Mortgage-backed securities	27,996,757	-	27,996,757	-
Municipals	<u>14,315,660</u>	<u>-</u>	<u>14,315,660</u>	<u>-</u>
Total assets measured at fair value	<u>\$ 43,344,629</u>	<u>\$ -</u>	<u>\$ 43,344,629</u>	<u>\$ -</u>
Total liabilities measured at fair value	<u>\$ -</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ -</u>
 <u>December 31, 2010</u> 				
Investment securities available-for-sale:				
U.S. Government agencies	\$ 1,017,757	\$ -	\$ 1,017,757	\$ -
Mortgage-backed securities	15,756,190	-	15,756,190	-
Municipals	<u>8,893,397</u>	<u>-</u>	<u>8,893,397</u>	<u>-</u>
Total assets measured at fair value	<u>\$ 25,667,344</u>	<u>\$ -</u>	<u>\$ 25,667,344</u>	<u>\$ -</u>
Total liabilities measured at fair value	<u>\$ -</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ -</u>

Notes to Financial Statements

Note 10. Fair Value of Financial Instruments, continued

Non-recurring Fair Value

The table below presents the recorded amount of assets and liabilities measured at fair value on a non-recurring basis.

<u>December 31, 2011</u>	<u>Total</u>	<u>Level 1</u>	<u>Level 2</u>	<u>Level 3</u>
Impaired loans	\$ 6,431,474	\$ -	\$ -	\$ 6,431,474
Foreclosed properties	186,327	-	-	186,327
Total assets recorded at fair value	<u>\$ 6,617,801</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ 6,617,801</u>
Total liabilities recorded at fair value	<u>\$ -</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ -</u>
 <u>December 31, 2010</u>				
Impaired loans	\$ 3,860,931	\$ -	\$ -	\$ 3,860,931
Foreclosed properties	1,409,000	-	-	1,409,000
Total assets recorded at fair value	<u>\$ 5,269,931</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ 5,269,931</u>
Total liabilities recorded at fair value	<u>\$ -</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ -</u>

Estimated Fair Value of Other Financial Instruments

GAAP also requires disclosure of fair value information about financial instruments carried at book value in the balance sheet. In cases where quoted market prices are not available, fair values are based on estimates using present value or other valuation techniques. Those techniques are significantly affected by the assumptions used, including the discount rate and estimates of future cash flows. In that regard, the derived fair value estimates cannot be substantiated by comparison to independent markets and, in many cases, could not be realized in immediate settlement of the instruments. Accordingly, the aggregate fair value amounts presented do not represent the underlying value of the Bank.

The following methods and assumptions were used by the Bank in estimating its fair value disclosures for financial instruments not measured at fair value on the balance sheets:

Cash and due from banks: The carrying amounts reported in the balance sheet for cash and due from banks approximate their fair values.

Time and other interest-bearing deposits with financial institutions: The carrying amounts of interest-bearing deposits maturing within twelve months approximate their fair values. Fair values of other interest-bearing deposits are estimated using discounted cash flow analyses based on current rates for similar types of deposits.

Securities: Fair values for securities, excluding restricted equity securities, are based on quoted market prices. The carrying value of restricted equity securities approximates fair value based on the redemption provisions.

Loans receivable: For variable-rate loans that reprice frequently and with no significant change in credit risk, fair values are based on carrying amounts. The fair values for other loans are estimated using discounted cash flow analysis, based on interest rates currently being offered for loans with similar terms to borrowers of similar credit quality. Loan fair value estimates include judgments regarding future expected loss experience and risk characteristics. Fair values for impaired loans are estimated using discounted cash flow analysis or underlying collateral values, where applicable. The carrying amount of accrued interest receivable approximates its fair value.

Notes to Financial Statements

Note 10. Fair Value of Financial Instruments, continued

Estimated Fair Value of Other Financial Instruments, continued

Deposit liabilities: The fair values disclosed for demand deposits (e.g., interest and non-interest checking, passbook savings, and certain types of money market accounts) are, by definition, equal to the amount payable on demand at the reporting date (i.e., their carrying amounts). The carrying amounts of variable-rate, fixed-term money market accounts and certificates of deposit approximate their fair values at the reporting date. Fair values for fixed-rate certificates of deposit are estimated using a discounted cash flow calculation that applies interest rates currently being offered on certificates to a schedule of aggregated expected monthly maturities on time deposits.

Federal funds purchased and securities sold under agreements to repurchase: The carrying amounts of federal funds purchased, borrowings under repurchase agreements, and other short-term borrowings maturing within ninety days approximate their fair values. Fair values of other short-term borrowings are estimated using discounted cash flow analyses based on the Bank's current incremental borrowing arrangements.

Borrowings: The fair values of the Bank's borrowings are estimated using discounted cash flow analyses based on the Bank's current incremental borrowing rates for similar types of borrowing arrangements.

The carrying amounts and estimated fair values of the Bank's financial instruments are as follows (dollars in thousands):

	December 31, 2011		December 31, 2010	
	Carrying Amount	Fair Value	Carrying Amount	Fair Value
<i>Financial assets</i>				
Cash and due from banks	\$ 2,293	\$ 2,293	\$ 1,390	\$ 1,390
Time and other interest-bearing deposits with financial institutions	18,358	18,358	26,715	26,715
Investment securities, available-for-sale	43,345	43,345	25,667	25,667
Investment securities, held-to-maturity	500	517	500	506
Restricted equity securities	1,924	1,924	2,077	2,077
Loans, net of allowance for loan losses	143,131	145,557	133,203	134,087
<i>Financial liabilities</i>				
Deposits	151,463	151,544	126,153	124,658
Federal funds purchased and securities sold under agreements to repurchase	3,449	3,449	4,792	4,792
FHLB borrowings	31,750	32,093	39,000	39,920
<i>Off-balance sheet</i>				
Commitments to extend credit and standby letters of credits	-	-	-	-

Notes to Financial Statements

Note 11. Earnings per Share

The following table details the computation of basic and fully diluted earnings per share for the periods ended December 31, 2011 and 2010.

	<u>2011</u>	<u>2010</u>
Net income (income available to common shareholders)	\$ 675,976	\$ 1,233,077
<i>Weighted average common shares outstanding</i>	2,594,873	2,162,400
Effect of dilutive securities, options	-	-
<i>Weighted average common shares outstanding, diluted</i>	<u>2,594,873</u>	<u>2,162,400</u>
<i>Basic earnings per common share</i>	\$.26	\$.48
<i>Dilutive earnings per common share</i>	<u>\$.26</u>	<u>\$.48</u>

At December 31, 2011 and 2010, there were 446,758 and 471,782, respectively, options outstanding that were not included in the calculation of diluted earnings per common share because their exercise price exceeded market value.

During 2011, the Bank declared and distributed a 6 for 5 stock split affected in the form of a 20% stock dividend. Share and per share information in this report has been adjusted to retroactively reflect this stock dividend when appropriate.

Note 12. Benefit Plans

Defined Contribution Plan

The Bank maintains a profit sharing plan pursuant to Section 401(k) of the Internal Revenue Code. The plan covers substantially all employees who are 21 years of age upon date of hire. Participants may contribute a percentage of compensation, subject to a maximum allowed under the Code. In addition, the Bank makes certain matching contributions and may make additional contributions at the discretion of the Board of Directors. Bank expense relating to the plan for the years ended December 31, 2011 and 2010 amounted to \$137,695 and \$97,130, respectively.

Flexible Benefits Plan

The Bank maintains a Flexible Benefits Plan which allows employees to make pre-tax salary contributions to a "flexible spending account" (FSA) to pay qualifying health and dependent care expenses.

Cash Value of Life Insurance

The Bank is the owner and beneficiary of life insurance policies on certain executive officers. Policy cash values on the balance sheet totaled \$3,203,886 and \$3,114,224 at December 31, 2011 and 2010, respectively.

Stock Option Plans

In 2006 the Bank adopted both an Incentive Stock Option (ISO) Plan and a Nonstatutory Stock Option (NSO) Plan. Under each plan up to 259,200 shares (reflects 2011's stock split) may be issued for a total of 518,400 shares (reflects 2011s stock split). Options granted under both plans expire no more than 10 years from date of grant. Option exercise prices under both plans shall be set by the Board of Directors at the date of grant, but shall not be less than 100% of fair market value of the related stock at the date of the grant. Options vest over five and three year periods from the date of the grant for the ISO and NSO Plans, respectively.

Compensation cost relating to share-based payment transactions is recognized in the financial statements with measurement based upon the fair value of the equity or liability instruments issued. For the years ended December 31, 2011 and 2010, the Bank recognized \$71,419 and \$116,010 respectively, in compensation expense for stock options.

At December 31, 2011, unrecognized compensation costs amounted to \$124,928 which will be expensed over the next five years.

Notes to Financial Statements

Note 12. Benefit Plans, continued

Stock Option Plans, continued

The weighted average fair value of each stock option grant is estimated on the date of grant using the Black-Scholes option-pricing model. The expected volatility is based on historical volatility. The risk-free interest rates for periods within the contractual life of the awards are based on the U.S. Treasury yield curve in effect at the time of the grant. The expected life is based on historical exercise experience. The dividend yield assumption is based on the Bank's history and expectation of dividend payouts.

Activity under the plans during the years ended December 31, 2011 and 2010 are summarized below:

	<u>Incentive Plan</u>		<u>Non-statutory Plan</u>	
	<u>Available for Grant</u>	<u>Granted</u>	<u>Available for Grant</u>	<u>Granted</u>
<i>Balance December 31, 2009</i>	61,742	151,858	-	216,000
Forfeited	-	-	-	-
Granted	(25,300)	25,300	-	-
Exercised	-	-	-	-
<i>Balance December 31, 2010</i>	<u>36,442</u>	<u>177,158</u>	<u>-</u>	<u>216,000</u>
Stock split	7,289	35,431	7	43,193
Forfeited	88,484	(88,484)	-	-
Granted	(63,460)	63,460	-	-
Exercised	-	-	-	-
<i>Balance December 31, 2011</i>	<u>68,755</u>	<u>187,565</u>	<u>7</u>	<u>259,193</u>

No cash was received during 2011 or 2010 for options exercised.

Notes to Financial Statements

Note 12. Benefit Plans, continued

Additional information relating to the plan is listed below:

	<u>2011</u>	<u>2010</u>
<i>Outstanding options at December 31:</i>		
Weighted average exercise price:		
Beginning of the year	\$ 9.32	\$ 9.44
End of the year	\$ 9.00	\$ 9.32
Range of exercise prices:		
From	\$ 6.67	\$ 7.56
To	\$ 11.46	\$ 11.46
Weighted average remaining contractual life in years	5.47	6.07
Aggregate intrinsic value	\$ 37	\$ 4,554
Exercisable options	363,878	374,976
Weighted average exercise price of exercisable options	\$ 9.28	\$ 9.28
Weighted average remaining contractual life of exercisable options, in years	4.75	5.69
Aggregate intrinsic value of exercisable options	\$ -	\$ -
<i>Weighted average exercise price of options:</i>		
Granted during the year	\$ 6.67	\$ 7.56
Exercised during the year	\$ -	\$ -
Forfeited during the year	\$ 9.04	\$ -
Expired during the year	\$ -	\$ -
<i>Grant-date fair value:</i>		
Options granted during the year, total	\$ 101,992	\$ 60,723
Options granted during the year, weighted average	\$ 1.61	\$ 2.00
<i>Significant assumptions used in determining fair value:</i>		
Risk-free interest rate	2.32%	3.16%
Expected life in years	7%	7
Expected dividend yield	.75%	.75%
Expected volatility	20%	20%

Note 13. Income Taxes

Current and Deferred Income Tax Components

The components of income tax expense for the years ended December 31, 2011 and 2010 are as follows:

	<u>2011</u>	<u>2010</u>
Current	\$ 733,977	\$ 749,558
Deferred	(529,977)	(185,763)
	<u>\$ 204,000</u>	<u>\$ 563,795</u>

Notes to Financial Statements

Note 13. Income Taxes, continued

Rate Reconciliation

A reconciliation of income tax expense computed at the statutory federal income tax rate to income tax expense included in the statement of operations for the period ended December 31, 2011 and 2010 are as follows:

	<u>2011</u>	<u>2010</u>
Tax at statutory federal rate	\$ 299,192	\$ 610,936
Compensation expense	33,414	39,684
Exempt interest income	(175,885)	(116,000)
State taxes	55,981	125,068
Other	(8,702)	(36,149)
Deferred tax asset valuation allowance change	-	(59,744)
	<u>\$ 204,000</u>	<u>\$ 563,795</u>

Deferred Income Tax Analysis

The significant components of net deferred tax assets at December 31, 2011 and 2010 are summarized as follows:

	<u>2011</u>	<u>2010</u>
<i>Deferred tax assets</i>		
Allowance for loan losses	\$ 1,431,771	\$ 1,060,673
Pre-opening expenses	165,749	183,046
Stock-based compensation	298,616	299,163
Deferred gain on termination of swap	-	58,606
Write down of other real estate owned	15,420	86,737
Accrued compensation	292,832	14,312
Nonaccrual interest	36,637	15,414
Deferred tax asset	<u>2,241,025</u>	<u>1,717,951</u>
<i>Deferred tax liabilities</i>		
Unrealized gain on securities available for sale	769,883	275,364
Depreciation	35,634	47,012
Prepaid expenses	23,332	26,547
Deferred loan costs	47,053	44,516
Accretion of bond discount	917	25,414
Deferred tax liability	<u>876,819</u>	<u>418,853</u>
Net deferred tax asset	<u>\$ 1,364,206</u>	<u>\$ 1,299,098</u>

Based on the Bank's historical and current earnings, management believes it is more likely than not the Bank will realize the benefits of the deferred tax assets.

The Bank has analyzed the tax positions taken or expected to be taken in its tax returns and concluded it has no liability related to uncertain tax positions. Years ended December 31, 2007 through December 31, 2010 remain open for audit for all major jurisdictions.

Note 14. Commitments and Contingencies

Litigation

In the normal course of business the Bank may be involved in various legal proceedings. The Bank was not involved in any litigation during the years ended December 31, 2011 and 2010.

Notes to Financial Statements

Note 14. Commitments and Contingencies, continued

Financial Instruments with Off-balance-sheet Risk

The Bank is party to financial instruments with off-balance-sheet risk in the normal course of business to meet the financing needs of its customers. These financial instruments include commitments to extend credit and standby letters of credit. These instruments involve, to varying degrees, credit risk in excess of the amount recognized in the balance sheet.

The Bank's exposure to credit loss in the event of nonperformance by the other party to the financial instrument for commitments to extend credit and standby letters of credit is represented by the contractual amount of those instruments.

The Bank uses the same credit policies in making commitments and conditional obligations as for on-balance-sheet instruments. A summary of the Bank's commitments at December 31, 2011 and 2010 are as follows:

	<u>2011</u>	<u>2010</u>
Commitments to extend credit	\$ 22,306,000	\$ 24,386,000
Standby letters of credit	<u>50,000</u>	<u>319,000</u>
	<u>\$ 22,356,000</u>	<u>\$ 24,705,000</u>

Commitments to extend credit are agreements to lend to a customer as long as there is no violation of any condition established in the contract. Commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee. Since many of the commitments are expected to expire without being drawn upon, the total commitment amounts do not necessarily represent future cash requirements. The Bank evaluates each customer's creditworthiness on a case-by-case basis. The amount of collateral obtained, if deemed necessary by the Bank upon extension of credit, is based on management's credit evaluation of the party. Collateral held varies, but may include accounts receivable, inventory, property and equipment, residential real estate and income-producing commercial properties.

Standby letters of credit are conditional commitments issued by the Bank to guarantee the performance of a customer to a third party. Those guarantees are primarily issued to support public and private borrowing arrangements. The credit risk involved in issuing letters of credit is essentially the same as that involved in extending loan facilities to customers. Collateral held varies as specified above and is required in instances which the Bank deems necessary.

Concentrations of Credit Risk

Substantially all of the Bank's loans and commitments to extend credit have been granted to customers in the Bank's market area and such customers are generally depositors of the Bank. The concentrations of credit by type of loan are set forth in Note 4. The distribution of commitments to extend credit approximates the distribution of loans outstanding. The Bank's primary focus is toward small and medium sized commercial businesses, and accordingly, it does not have a significant number of credits to any single borrower or group of related borrowers in excess of \$4.1 million.

The Bank from time to time may have cash and cash equivalents on deposit with financial institutions that exceed federally-insured limits.

Other Commitments

The Bank has entered into several change of control agreements with certain officers detailing the Bank's obligation in the event of a merger or acquisition.

Notes to Financial Statements

Note 15. Regulatory Restrictions

Dividends

The Bank, as a North Carolina banking corporation, may pay dividends only out of undivided profits (retained earnings) as determined pursuant to North Carolina General Statutes Section 53-87. However, regulatory authorities may limit payment of dividends by any bank when it is determined that such a limitation is in the public interest and is necessary to ensure financial soundness of the bank. Additionally, dividends for the first three years of operations of new banks are explicitly prohibited by the North Carolina Banking Commission and the Federal Deposit Insurance Corporation unless special exceptions are made.

Capital Requirements

The Bank is subject to various regulatory capital requirements administered by federal banking agencies. Failure to meet minimum capital requirements can initiate certain mandatory (and possibly additional discretionary) actions by regulators that, if undertaken, could have a direct material effect on the Bank's financial statements. Under capital adequacy guidelines and the regulatory framework for prompt corrective action, the Bank must meet specific capital guidelines that involve quantitative measures of the Bank's assets, liabilities, and certain off-balance-sheet items as calculated under regulatory accounting practices. The Bank's capital amounts and classification are also subject to qualitative judgments by the regulators about components, risk weightings, and other factors.

Quantitative measures established by regulation to ensure capital adequacy require the Bank to maintain minimum amounts and ratios (set forth in the table below) of total and Tier I capital to risk-weighted assets, and of Tier I capital to average assets, as all those terms are defined in the applicable regulations. As of December 31, 2011 and 2010, Management believes that the Bank met all capital adequacy requirements to which it was subject.

As of December 31, 2011, the most recent notification from the Federal Deposit Insurance Corporation categorized the Bank as well capitalized under the regulatory framework for prompt corrective action. To be categorized as well capitalized, an institution must maintain minimum total risk-based, Tier I risk-based and Tier I leverage ratios as set forth in the following table. There are no conditions or events since the notification that management believes have changed the Bank's category.

The Bank's actual capital amounts and ratios are also presented in the table (dollars in thousands).

	<u>Actual</u>		<u>Minimum Capital Requirement</u>		<u>Minimum To Be Well Capitalized Under Prompt Corrective Action Provisions</u>	
	<u>Amount</u>	<u>Ratio</u>	<u>Amount</u>	<u>Ratio</u>	<u>Amount</u>	<u>Ratio</u>
<i>December 31, 2011</i>						
Total Capital						
(to Risk-Weighted Assets)	\$ 28,644	18.9%	\$ 12,099	8.0%	\$ 15,124	10.0%
Tier I Capital						
(to Risk-Weighted Assets)	\$ 26,807	17.7%	\$ 6,050	4.0%	\$ 9,074	6.0%
Tier I Capital						
(to Average Assets)	\$ 26,807	12.4%	\$ 8,663	4.0%	\$ 10,829	5.0%
<i>December 31, 2010</i>						
Total Capital						
(to Risk-Weighted Assets)	\$ 27,239	18.7%	\$ 11,311	8.0%	\$ 14,138	10.0%
Tier I Capital						
(to Risk-Weighted Assets)	\$ 25,456	17.5%	\$ 5,655	4.0%	\$ 8,483	6.0%
Tier I Capital						
(to Average Assets)	\$ 25,456	13.4%	\$ 8,016	4.0%	\$ 10,019	5.0%

Notes to Financial Statements

Note 16. Comprehensive Income

Comprehensive income consists of net income and other comprehensive income. Other comprehensive income includes unrealized gains and losses on securities available-for-sale (AFS) and unrealized gains and losses on cash flow hedges which are also recognized as separate components of equity.

The components of other comprehensive income are as follows:

	<u>Years Ended December 31,</u>	
	<u>2011</u>	<u>2010</u>
Changes in unrealized gains and losses on AFS securities	\$ 1,403,393	\$ (253,184)
Realized gains	<u>(120,594)</u>	<u>-</u>
Net gains and losses on AFS securities	1,282,799	(253,184)
Less deferred tax (expense) benefit	<u>(494,519)</u>	<u>97,603</u>
Total other comprehensive income (loss)	<u>\$ 788,280</u>	<u>\$ (155,581)</u>

The components of accumulated other comprehensive income, included in shareholders' equity, are as follows:

	<u>2011</u>	<u>2010</u>
Unrealized gain and losses on AFS securities	\$ 1,997,103	\$ 714,304
Less deferred tax expense	<u>(769,883)</u>	<u>(275,364)</u>
Total accumulated other comprehensive income	<u>\$ 1,227,220</u>	<u>\$ 438,940</u>

Note 17. Transactions with Related Parties

The Bank has entered into transactions with its directors, significant shareholders and their affiliates (related parties). Such transactions were made in the ordinary course of business on substantially the same terms and conditions, including interest rates and collateral, as those prevailing at the same time for comparable transactions with other customers, and did not, in the opinion of management, involve more than normal credit risk or present other unfavorable features.

Aggregate loan transactions with related parties were as follows:

	<u>2011</u>	<u>2010</u>
<i>Balance, beginning</i>	\$ 7,643,421	\$ 8,175,876
New loans and advances	4,610,921	2,512,620
Repayments	<u>(4,529,814)</u>	<u>(3,045,075)</u>
<i>Balance, ending</i>	<u>\$ 7,724,528</u>	<u>\$ 7,643,421</u>

Deposit transactions with related parties at December 31, 2011 and 2010 were insignificant.

Board of Directors and Bank Management

Board of Directors

Carole S. Anders *Community Volunteer*

Ronald A. Batchelor, CPA *Partner, Batchelor, Tillery & Roberts, LLP*

Robert A. Boyette *President, Ashland Construction Co.*

Ronald P. Gibson *Retired, Former CEO of Highwoods Properties, Inc.*

Robert L. Guthrie *Retired, Insurance Business*

R. Merrill Hunter, MD *Cardiovascular Surgeon*
Carolina Cardiovascular Associates, PA

R. Doyle Parrish *CEO, Summit Hospitality Group Ltd.*

Michael S. Patterson *Chairman, President and Chief Executive Officer CapStone Bank*

Edythe M. Poyner *President, Capital Land Investment Co.*

Richard A. Urquhart, III *Chief Operating Officer, Investors Management Corporation*

Sydnor M. White, Jr. *President, White Oak Commercial, Inc.*

Charles P. Wilkins *Attorney/Member*
Broughton, Wilkins, Sugg, and Thompson, PLLC

Bank Management

Michael S. Patterson *Chairman, President and Chief Executive Officer*

Robert E. Branch *Executive Vice President – Chief Banking Officer*

Debra L. Lee *Executive Vice President – Chief Financial Officer*

W. Craig George *Executive Vice President – Chief Credit Officer*

Susan C. Gilbert *Senior Vice President – Corporate Secretary*

Shareholder Information

Annual Meeting

The annual meeting of shareholders will be held on Wednesday, May 16, 2012 at 10:30 a.m. at North Ridge Country Club, 6612 Falls of Neuse Road, Raleigh, North Carolina.

Requests for Information

Requests for information should be directed to Ms. Susan C. Gilbert, Corporate Secretary, at CapStone Bank, 4505 Falls of Neuse Road, Suite 150, Raleigh, North Carolina, 27609; telephone (919) 256-6803.

Independent Auditors

Elliott Davis, PLLC
Certified Public Accountants
Post Office Box 760
Galax, Virginia 24333

Corporate Counsel

Gaeta & Eveson, P.A.
Attorneys at Law
700 Spring Forest Road
Suite 335
Raleigh, North Carolina 27609

Stock Transfer Agent

First Shareholder Services
Post Office Box 29522 (FCC61)
Raleigh, North Carolina 27626

Federal Deposit Insurance Corporation

The Bank is a member of the FDIC. This statement has not been reviewed, or confirmed for accuracy or relevance by the Federal Deposit Insurance Corporation.

Offices

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Raleigh, North Carolina 27609

Loan Production

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Cary, North Carolina 27511

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